Complying With the CEO Pay Ratio Rule in 2019

As we move towards the start of the 2019 proxy season, we also begin the second year of compliance with Item 402(u) of Regulation S-K, the CEO pay ratio rule. While compliance should generally be easier for companies that had to make their initial pay ratio disclosures in 2018, there are still some important decisions that will have to be made as part of the second year compliance process, primarily involving the selection of the median employee whose compensation will be compared to that of the Chief Executive Officer.

This Thoughtful Disclosure Alert summarizes the rules relating to whether a company may use in year two the same median employee that it used in its year one disclosure, or whether it must go through the process of identifying a new median employee for purposes of its 2019 disclosure.

Background

Item 402(u) of Regulation S-K, the pay ratio disclosure rule, requires most public companies to disclose in their annual report on Form 10-K and definitive proxy statement the ratio of the median of the annual total compensation of their employees (other than the Chief Executive Officer) and the annual total compensation of their Chief Executive Officer. To somewhat ease the often considerable burden associated with identifying the median employee whose compensation will be compared to that of the CEO, the rule generally requires companies to identify the median employee only once every three years and then just calculate the total compensation for that employee each year.

In other words, a company may use the same median employee for up to three years, assuming that doing so is reasonable. Specifically, the rule permits the use of the same median employee as long as during the company's last completed fiscal year there has been no change in its employee population or employee compensation arrangements that it reasonably believes would result in a significant change to its pay ratio disclosure.

Change in Employee Compensation Arrangements

If a company has experienced a change in its employee compensation arrangements during the last completed fiscal year that it reasonably believes would result in a significant change to its pay ratio disclosure, then it must go through the process of identifying a new median employee. Use of the prior year's median employee is not permitted. The rule does not offer any insight into what constitutes a change in compensation arrangements and the SEC Staff has not provided any guidance on what type of change would prompt the need for a new median employee.

Presumably, adding a new or eliminating an existing compensation element to its employee compensation program, such as the introduction of an annual incentive plan or a decision to grant (or not grant) equity awards broadly, would be the type of action that may preclude using the same median employee in a subsequent year. Similarly, providing significant and systematic compensation increases to a single category of employees (such as engineers or other technical employees) could necessitate a re-evaluation of the use of the prior year's median employee.

While, in our experience, programmatic changes to broad employee compensation arrangements do not happen frequently, ultimately, each situation will have to be evaluated on its own facts and circumstances. In addition, the change has to be one that the company reasonably believes will have a significant impact on its pay ratio disclosure.

Change in Employee Population

If a company has experienced a change in its employee population during the last completed fiscal year that it reasonably believes would result in a significant change to its pay ratio disclosure, then it also must go through the process of identifying a new median employee. Such a change can either be an increase, such as the result of a major acquisition or through material organic growth, or a decrease, such as a reduction in force or a major divestiture, in the employee population. Once again, in this instance use of the prior year's median employee is not permitted. And, once again, there is no guidance either in the rule or from the SEC

Staff to assist in determining when any such change would be considered to have significant impact on the pay ratio disclosure.

In today's dynamic environment, particularly for companies in high-growth technology industry sectors, the chances of a significant change in the employee population are probably more likely than a change in compensation arrangements, so this is a fact pattern that companies will need to consider carefully.

Change in Median Employee Circumstances

A third fact pattern that may arise involves the individual employee who was selected as the prior year's median employee. The rule contemplates that, notwithstanding the absence of a change in a company's employee population or employee compensation arrangements, it may no longer be appropriate to use that employee in the pay ratio disclosure because of a change in that individual's circumstances, such as having terminated employment, received a promotion with a material change in compensation, or otherwise experienced a significant change in their individual compensation.

In this instance, if the company reasonably believes that the change in circumstances would result in a significant change in its pay ratio disclosure, then it may use another employee whose compensation is substantially similar to the original median employee based on the compensation measures to select the original median employee. In other words, the company can use a second employee from its original identification process with substantially similar compensation as its median employee. It does not have to go through the process of identifying a new median employee in this situation.

Additional Disclosure Required

Where a company has concluded that it may use the median employee from its 2018 disclosure in its 2019 disclosure, it must disclose that it is using the same median employee in its pay ratio calculation and describe briefly the basis for its reasonable belief that such use will not significantly affect its pay ratio disclosure. For example, the company could disclose that there has been no change in its employee population or employee compensation arrangements that it believes would significantly impact the pay ratio disclosure. Of course, where the company has re-identified its median employee, it should say that it has done so, which will be accompanied by a brief description of the methodology that was used to identify the new median employee.

Finally, while the rule is silent on the matter, presumably where a company has changed its median employee because the original median employee is no longer suitable for purposes of the disclosure, a company should disclose that it has replaced the original employee with a new median employee based on its original calculation.

Need Assistance?

Compensia can assist companies in preparing their CEO pay ratio disclosure, including developing a process for identifying their "median employee." If you would like assistance in understanding how the CEO pay ratio disclosure requirement will affect your company, preparing your CEO pay ratio disclosure, or if you have any questions on the subjects addressed in this Thoughtful Disclosure Alert, please contact Mark A. Borges.■

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